

procured from the private reinsurance market and was the primary source of anticipated savings that insurers were required to reflect in rate filings with the Office of Insurance Regulation.

The bill requires the FHCF to offer the option to qualified insurers to purchase an additional \$10 million of coverage for 2008, as was made available in 2006 and 2007, but reduces the reimbursement from 100 percent to 70 percent of the insurer's losses.

Currently, the FHCF is administered by the State Board of Administration (SBA), which consists of the Governor, the Chief Financial Officer, and the Attorney General. The bill creates a Division of the Florida Hurricane Catastrophe Fund administratively housed within the SBA, and subject to a governing board consisting of the Governor and the Cabinet, consisting of the Chief Financial Officer, the Attorney General, and the Agriculture Commissioner. Under the bill, the board-appointed director of the division is designated to administer the fund, rather than the SBA.

This bill substantially amends the following sections of the Florida Statutes: 215.555, 215.557, 215.5586, 215.559, 215.5595, and 627.0628.

II. Present Situation:

The Florida Hurricane Catastrophe Fund (FHCF)

The FHCF is a tax-exempt trust fund created in 1993 after Hurricane Andrew, as a form of mandatory reinsurance for residential property insurers (s. 215.555, F.S.). All insurers that write residential property insurance in Florida are required to buy, through the fund, reimbursement coverage (reinsurance) on their residential property exposure. The fund is administered by the SBA and is a tax-exempt source of reimbursement to property insurers for a selected percentage (45, 75, or 90 percent) of hurricane losses above the insurer's retention (deductible). The fund provides insurers an additional source of reinsurance that is significantly less expensive than what is available in the private market, enabling insurers to generally write more residential property insurance in the state than would otherwise be written. Because of the low cost of coverage from the fund, the fund acts to lower residential property insurance premiums for consumers. The fund must charge insurers the "actuarially indicated" premium for the coverage provided, based on hurricane loss projection models found acceptable by the Florida Commission on Hurricane Loss Projection Methodology.

Insurers must first pay hurricane losses up to their "retention" for each hurricane, similar to a deductible, before being reimbursed by the FHCF coverage. In 2005, legislation addressed multiple storm seasons by providing that the retention is reduced to one-third of the regular retention for a third hurricane and each additional hurricane. The full retention is applied to the two hurricanes causing the greatest losses to the insurer. The retention is adjusted annually based on the fund's exposure. For the 2007 hurricane season, the retention was approximately \$6.1 billion for all insurers combined. A retention is calculated for each insurer based on its share of fund premiums.

For the 2007 hurricane season, the fund provided \$15.85 billion in mandatory coverage. That amount is adjusted annually based on the percentage growth in fund exposure, but not to exceed

the dollar growth in the cash balance of the fund. The maximum coverage amount for each insurer is based on that insurer's share of the total premiums paid to the fund.

Chapter 2007-1, L.O.F., adds two additional layers of optional coverage that property insurers may buy for the 2007, 2008, and 2009 hurricane seasons:

- Temporary Increase in Coverage Limit options that allow an insurer to purchase additional reinsurance for its share of up to \$12 billion, in \$1 billion increments, above the FHCF annual limit of the mandatory coverage (up to a total of approximately \$28 billion). The SBA may further increase the limits by an additional \$4 billion (up to \$32 billion). The SBA did not increase the limits in 2007.
- Temporary Emergency Additional Coverage Options (TEACO), that allows residential property insurers to purchase additional coverage below each insurer's market share of the FHCF retention. For 2007, the fund retention was \$6.1 billion. The TEACO options allow an insurer to select its share of a retention level of \$3 billion, \$4 billion, or \$5 billion, to cover 90 percent, 75 percent, or 45 percent of its losses up to the normal retention for the mandatory FHCF coverage.

Chapter 2007-1, L.O.F., also allows each eligible insurer to purchase up to \$10 million in additional FHCF coverage, explained in more detail below.

If the cash balance of the fund is not sufficient to cover losses, the law allows the issuance of revenue bonds of up to 30-year terms, funded by emergency assessments on property and casualty policyholders. The fund is authorized to levy emergency assessments against all property and casualty insurance premiums paid by policyholders (other than workers' compensation, flood, medical malpractice, and accident and health insurance), including auto insurance and surplus lines policyholders. Annual assessments are capped at six percent of premium with respect to losses from any one year and a maximum of ten percent of premium to fund hurricane losses from multiple years.

Temporary Increase in Coverage Limit and the Current Financial Status of the Fund

Insurers must pay a premium for the optional TICL coverage, established by the SBA under the same method it uses for determining "actuarially indicated" premiums for the mandatory FHCF coverage. As historically applied by the SBA, the actuarially indicated premium is the premium that is equal to the estimated average annual loss for the coverage purchased, based on a weighted average of the hurricane loss models approved by the Florida Commission on Hurricane Loss Projection Methodology, plus the SBA's costs of administration. For the TICL coverage options, the premium was 2.2 percent of the coverage amount, for an insurer electing to buy its full share of the \$12 billion TICL limits for 2007. This 2.2 percent "rate-on-line" is much less expensive than the premiums charged by private reinsurers, which range from about 10 to 20 percent for this level of coverage. This is the primary source of expected premium savings under the new law. Insurers took nearly full advantage of the TICL options, purchasing about \$11.43 billion of the \$12 billion offered, in exchange for a total premium of \$242 million.

The Florida Hurricane Catastrophe Fund had potential reimbursement obligations to insurers of \$27.85 billion for the 2007 hurricane season. This amount consisted of:

- \$15.85 billion of mandatory FHCF coverage (subject to a growth factor each year).
- \$11.43 billion of TICL coverage selected by insurers (of the optional \$12 billion offered only for 2007, 2008, and 2009).
- \$557 million selected by limited apportionment insurers eligible to purchase up to \$10 million additional coverage (offered only for 2007).

To fully meet the potential \$27.85 billion obligation for 2007, the fund relied on:

- \$2.08 billion estimated year-end cash balance.
- \$6.3 billion in proceeds from pre-event notes that have already been issued (for short-term liquidity needs).
- Up to \$25.75 billion in bonds to be issued after a hurricane (which could be used to retire the pre-event notes).

The fund had potential reimbursement obligations to insurers of \$27.85 billion for the 2007 hurricane season, for which the fund would have been required to issue up to \$25.75 billion in post-hurricane bonds. This would require an annual assessment of about five percent of premiums for 30 years. Even if this full obligation was triggered, the fund faces similar obligations for 2008 and 2009, due to the TICL options. The fund estimates that its maximum potential obligations for two years of about \$56 billion would require the maximum allowable assessment of ten percent annually for 30 years.

A bond issue of \$26 billion would be unprecedented and could require multiple bond issues over a period of time, while attempting to match time frames for insurers to pay claims and obtain timely reimbursement. The largest single long-term tax exempt financing ever done was for just over \$6 billion. However, there have been programs consisting of multiple financings over a period of several months for over \$10 billion. The largest single municipal financing was a taxable pension financing of \$10 billion. Over \$2.5 trillion in tax-exempt municipal bonds are currently held, of which over \$900 billion are held by households alone, reflecting a large market appetite for such securities. When interviewed by committee staff in November 2007, the financial advisor for the fund believed that the full amount of potential bonding needed could be issued by the fund over a 9 to 18 month period in a series of several issues. This belief was based in part on written opinions earlier that summer from each of the three senior managers of the fund, Bear Stearns, Goldman Sachs, and Lehman Brothers. Each indicated that the entire amount was achievable in a similar or shorter time frame. Currently, the continuing fallout of the subprime mortgage market and recent downgrades by financial rating organizations of insurers writing bond insurance have reportedly had a negative impact on the issuance of municipal bonds and other tax-exempt government issued bonds.

The largest insurance rating service, A.M. Best, expressed concern that the fund may be unable to issue bonds to produce its maximum claim-paying capacity through the TICL layer. In a February 2007 report issued shortly after the enactment of ch. 2007-1, L.O.F., A.M. Best raised the credit risk factor for reinsurance recoverables from the fund from 4 percent to 12 percent, meaning that, for purposes of rating the financial strength of an insurer, the reinsurance recoverables from the fund are reduced 12 percent.

The probability of the full \$28 billion loss (requiring a \$26 billion bond issue) to the fund occurring in any given year is relatively low, but not remote. This would require a hurricane resulting in about \$36 billion of insured residential hurricane losses (including the losses covered by the insurers' \$6.1 billion retention and 10 percent or greater co-pay), which is estimated to have a probability of 1.6 percent, or a hurricane that occurs about once every 65 years. By comparison, the probability of loss to the fund for the full \$15.85 billion mandatory coverage, but without the TICL coverage, is estimated to be about three percent, or once every 33 years. The probability of any loss at all to the fund (i.e., a loss above the industry retention of \$6.1 billion) is 13.33 percent, or once every 7.5 years.

Supplemental \$10 Million FHCF Coverage for Qualified Insurance Companies

In 2006, the Legislature authorized limited apportionment companies (having \$25 million in surplus or less and writing at least 25 percent of its premiums in Florida) to purchase coverage from the fund that reimburses the insurer for up to \$10 million in losses from each of two hurricanes for the 2006 hurricane season only. The coverage was priced at a 50 percent rate-on-line (e.g., \$5 million premium for \$10 million in coverage) with a free reinstatement of coverage for a second storm that triggers a recovery. The limited apportionment insurer's retention for such coverage was set at 30 percent of the company's surplus, thus an insurer with a surplus of \$20 million would have to pay \$6 million in losses before being reimbursed from the fund for its supplemental coverage.

In 2007, ch. 2007-1, L.O.F., reinstated the \$10 million supplemental coverage for the 2007 hurricane season. The availability for the coverage was limited to insurers that purchased the supplemental coverage in 2006, limited apportionment companies that began writing property insurance in 2007, and insurers approved to participate in either 2006 or 2007 for the Insurance Capital Build-Up Incentive Program. The statutory language authorizing the \$10 million supplemental coverage is set to expire on May 31, 2008, making it unavailable for the 2008 hurricane season or beyond.

Insurance Capital Build-Up Incentive Program

In 2006, the Legislature created the Insurance Capital Build-Up Incentive Program, which provides for the lending of state funds in the form of surplus notes to new or existing authorized residential property insurers under specified conditions. The maximum dollar amount of a surplus note is set at \$25 million. The surplus note is repayable to the state, with a 20 year term, at the ten-year Treasury Bond interest rate (with interest-only payments the first three years).

In order to qualify for a surplus note, an insurer that applied prior to June 1, 2007, was required to contribute new capital to its surplus equal to the amount of the surplus note. An insurer applying after that date but before June 1, 2008, was limited to a surplus note equal to one-half of its new capital contribution. The insurer's surplus, new capital, and the surplus note must total at least \$50 million. Additionally, the insurer must commit to meeting a minimum writing ratio of net written premium to surplus of at least two to one for the term of the surplus note, for residential property insurance in Florida that covers the peril of wind.

Chapters 2007-1 and 2007-90, L.O.F., revise the program to allow an insurer writing a specified amount of manufactured housing residential property insurance to qualify for a surplus note of up to \$7 million if the insurer's surplus, new capital, and the surplus note total at least \$14 million.

State Board of Administration

Section 4(e), Art. IV of the State Constitution establishes the State Board of Administration, consisting of the Governor, the Chief Financial Officer, and the Attorney General, who serve as the Board of Trustees for the SBA. Pursuant to s. 19-3.016, F.A.C., the board selects an executive director of the SBA, to serve as its chief administrative officer. The board delegates authority to the executive director to manage the financial affairs of the SBA.

The State Board of Administration serves as the financial manager of thirty investment funds on behalf of the State of Florida, comprising over \$184 billion in assets as of June 30, 2007. The primary function of the SBA is to administer the Florida Retirement System (FRS) Pension Plan, which comprises approximately 75 percent of the total assets under SBA management and is the fourth largest public retirement plan in the United States. The SBA also manages the FRS Investment Plan, which provides public employees with a portable alternative to the state pension plan.

The Florida Hurricane Catastrophe Fund is administered by the State Board of Administration pursuant to s. 215.555, F.S. The SBA is required to invest the moneys in the fund pursuant to the requirements placed on the SBA in ss. 215.44-215.52, F.S. All earnings must be retained in the fund. The SBA is authorized to employ or contract with staff and professionals as needed to administer the fund. The board has done just that, employing a senior fund officer who is in charge of much of the day-to-day management of the fund, a director of operations, and various attorneys, auditors, and analysts. The SBA has also contracted with Paragon Strategic Solutions, Inc., of Minneapolis, Minnesota, to aid in the administration of the fund.

The SBA also administers the Local Government Surplus Funds Trust Fund, which is the largest local government pool investment fund in the United States. This trust fund serves as a repository for investing local government surplus funds and is designed to help local governments maximize earnings and reduce the need for additional local taxes. According to the Office of Program Policy Analysis and Government Accountability, as of June 30, 2007, the market value of the Local Government Surplus Funds Trust Fund was \$30.95 billion. In November 2007, a number of local governments removed a total of approximately \$10 billion in assets from the Local Government Surplus Funds Trust Fund due to the reduction in value of securities backed by mortgages in which the SBA invested fund moneys.

III. Effect of Proposed Changes:

Section 1 amends s. 215.555, F.S., Florida Hurricane Catastrophe Fund as follows.